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IMF Report Commends Policies Set Out in *Advantage Canada,* the Long-Term Economic Plan of Canada's New Government

The Honourable Jim Flaherty, Minister of Finance, has received the annual statement of the International Monetary Fund (IMF) Mission on Canada, and is pleased with its positive assessment of the new long-term economic plan for Canada, *Advantage Canada.*

The IMF report praises Canada's New Government for its commitment to allocate unplanned surpluses to further lower the debt burden and the objective of eliminating Canada's net debt in less than a generation. The IMF also "welcomes" the government's commitment to use the interest savings from debt reduction to lower personal income taxes.

"*Advantage Canada* is a comprehensive road map for the future of Canada, and the IMF recognizes its significance and commends its approach," said Minister Flaherty. "*Advantage Canada* will help create the right conditions and opportunities for Canadians to be successful today and years from today."

The IMF report also commends the government for maintaining the inflation target of 1 to 3 per cent and predicts the strong performance of the Canadian economy will likely continue. The IMF believes Canada will see gross domestic product growth of about 2¾ per cent by mid-2007.

The IMF also recommends establishing a common securities regulator and emphasizes the value of harmonizing provincial sales taxes with the goods and services tax, consistent with commitments made by Canada's New Government in *Advantage Canada.*

A copy of the IMF statement is available on the Department of Finance website. The IMF will release its full report on Canada early next year.

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2007 Article IV Consultation with Canada
Preliminary Conclusions of the IMF Mission
December 7, 2006

1. ***The strong performance of the Canadian economy appears likely to continue, notwithstanding some recent slowing in growth***. Over the last year the economy has remained close to potential, as robust domestic demand has offset weakness in net exports from past currency appreciation, and the unemployment rate dipped to a 31-year low. Looking forward, resilient domestic demand and a diminution in the drag from the external sector—even in the face of the recent U.S. slowdown—will likely generate a recovery in growth to around 2¾ percent by mid-2007, broadly in line with potential, with inflation staying at about 2 percent.

2. ***External factors and the questions that surround productivity growth tilt risks to activity to the downside, while those related to inflation are smaller and more balanced***. Although strong household and corporate balance sheets suggest that domestic demand could surprise on the upside, a larger-than-anticipated slowing of activity in the United States, especially in the auto sector that has particularly significant spillovers for Canada, represents a key downside risk to growth.

3. ***The Bank of Canada has adroitly balanced these competing risks, and has appropriately left rates on hold since May***. While much will depend on incoming data, the current stance appears apposite given projections that headline and core inflation will remain around the middle of the target range, broadly symmetric inflation risks, approximately neutral real short-term interest rates, well-anchored inflation expectations, and moderate wage pressures. Given its success, we welcome the recent decision to leave the inflation targeting framework unchanged, albeit with somewhat greater flexibility regarding the inflation horizon, while at the same time continuing to explore the possibility of future improvements.

4. ***The financial sector is well positioned to cope with a turning of the global credit cycle***. Bank profitability and capital are high by historical (and, for the latter, international) standards and risks from the housing market are more limited than in other cyclically-advanced countries. At the same time, against a backdrop of a rapidly transforming global financial industry, there could be scope to improve financial sector efficiency and innovation by reducing regulatory thresholds to bank restructuring, as well as by moving toward establishing a national securities regulator.

5. ***We welcome the Fiscal Update's focus on fiscal prudence***. This includes planned debt reduction of C$3 billion a year, the intention to allocate unanticipated surpluses to further lower the debt burden, and the advancement of the commitment for reducing the federal debt ratio to 25 percent of GDP by a year to FY 2012–13. Given spending pressures that will begin to build from population aging, long-term fiscal sustainability requires a steady and significant decline in debt in coming decades, as well as further steps to contain

the growth of public health spending. The new objective to eliminate general government net debt by 2021 appropriately highlights the joint role of public pension plans and provincial-territorial governments in achieving a sustainable fiscal position, and could be usefully complemented by publishing a regular assessment of the long-term fiscal outlook.

6. ***The government's intention to lower the tax burden is appropriate***. The modest fiscal space after planned debt reduction would most usefully be used for growth enhancing cuts in personal and (in particular) corporate marginal effective tax rates. We welcome the government's commitment to using interest savings from debt reduction to lower personal income taxes and its objective of achieving the lowest marginal effective tax rate on new investment in the G-7. Marginal income tax rates are high by international standards, suggesting that reductions in this area would provide larger efficiency gains than further cuts to the Goods and Services Tax (GST). Indeed, with population aging implying a steady lowering in the ratio of workers to the overall population, there is a case for increasing the role of consumption taxes in the overall revenue effort.

7. ***The reforms suggested by the O'Brien panel would appropriately make the equalization system more predictable***. With differences in provincial fiscal capacity having widened as a result of the boom in world commodity prices, there is increasing urgency to return the program to a rules-based system and to avoid ad hoc bilateral arrangements. In particular, the suggestion to include resource revenues from all provinces in the standard for the calculation of equalization transfers is welcome.

8. ***With sound frameworks delivering macroeconomic stability, we welcome the focus on enhancing prosperity***. The theme of *Advantage Canada* is timely given modest investment by businesses in machinery and equipment and R&D, as well as a continuing productivity gap with the United States. We would particularly emphasize the value of initiatives to enhance the business environment. In addition to cutting high marginal effective tax rates on capital (including by promoting the harmonization of provincial sales taxes with the GST) and improving financial market intermediation, priorities could include phasing out restrictions to foreign direct investment, reducing the regulatory burden on firms, eliminating interprovincial barriers to trade in goods and labor mobility, and adapting the immigration system more fully to the needs of the economy.